United Nations E/ICEF/2003/AB/L.4

Economic and Social Council

Distr.: Limited
26 March 2003

Original: English

For action

United Nations Children's Fund
Executive Board
Annual session 2003
2-6 and 9 June 2003
Item 4 of the provisional agenda*

Review of the issue of establishing an operational reserve

Summary

The present report was prepared in response to Executive Board decision 2001/7 (E/ICEF/2001/6), in which the Board decided that UNICEF should continue its current financial management practice based on management of its short-term liquidity requirements on a cash-flow basis and should not establish a funded operational reserve. The Board decided to maintain the issue under review and consider it further during 2003.

Under its current policy, established by the Board in 1987, UNICEF must maintain year-end cash balances of regular resources income equal to approximately 10 per cent of the following year's regular resources income. The liquidity requirement is limited to regular resources income because of the self-funding requirement for other resources. Since the issue of an operational reserve was last discussed by the Executive Board in 2001, UNICEF has exceeded the 10-per-cent liquidity requirement, as it has done since the measure was established. In addition, UNICEF has met the informal liquidity ratio reported in its financial statements.

While an operational reserve can provide a short-term response mechanism to address an unforeseen shortfall in receipts and income, and can also afford an opportunity to earn marginally increased interest income through longer-term investments, an operational reserve creates a balance sheet asset at the expense of funding programmes, and may engender increased costs if it becomes necessary to break long-term investment commitments to utilize the funds.

The Executive Director therefore **recommends** that UNICEF continue to manage its liquidity in accordance with the liquidity requirement approved by the Executive Board and that it not establish a funded operational reserve.

* E/ICEF/2003/10.

03-29874 S (E) 010503

Introduction

1. The question of establishing an operational reserve was first raised by the Advisory Committee on Administrative and Budgetary Questions in 1999, in the context of its review of the biennial support budget for 2000-2001. The Advisory Committee recommended, and the secretariat agreed, that "UNICEF [would] analyse the advantages and disadvantages of establishing an operational reserve for both regular and other resources, taking into account the experience of other funds and programmes in this regard ... and the pertinent observations of the Advisory Committee ..." (E/ICEF/1999/AB/L.10, para. 9).

2. The report, "Establishment of an operational reserve" (E/ICEF/2001/AB/L.3) was presented to the Board at its first regular session of 2001, accompanied by a report of the Advisory Committee (E/ICEF/2001/AB/L.4), which noted that:

(a) The secretariat report analysed the advantages and disadvantages of establishing an operational reserve for both regular and other resources, taking into consideration the existing financial management framework and liquidity policy of UNICEF;

(b) The last time the Executive Board had reviewed the matter was in 1987, when the existing liquidity requirement was established. Under that requirement, UNICEF must maintain year-end cash balances of regular resources income equal to approximately 10 per cent of the following year's regular resources income. The liquidity requirement has been limited to regular resources income because of the self-funding requirement for other resources;

(c) The ratio between regular resources and other resources has changed over time with an ever increasing share being represented by other resources. Also, an increasing share of regular resources income is derived from private sources;

(d) The Executive Board should maintain the issue of establishing an operational reserve under review.

3. In its ensuing decision 2001/7 (E/ICEF/2001/6), the Executive Board decided that UNICEF should continue its current practice based on management of its short-term liquidity requirements on a cash-flow basis and should not establish a funded operational reserve. The Board decided to maintain the issue under review and consider it further at its first regular session of 2003, taking into account the report of the Advisory Committee on the biennial support budget for 2002-2003 and the report of the United Nations Board of Auditors for the biennium 2000-2001. The issue was subsequently allocated to the agenda of the 2003 annual session.

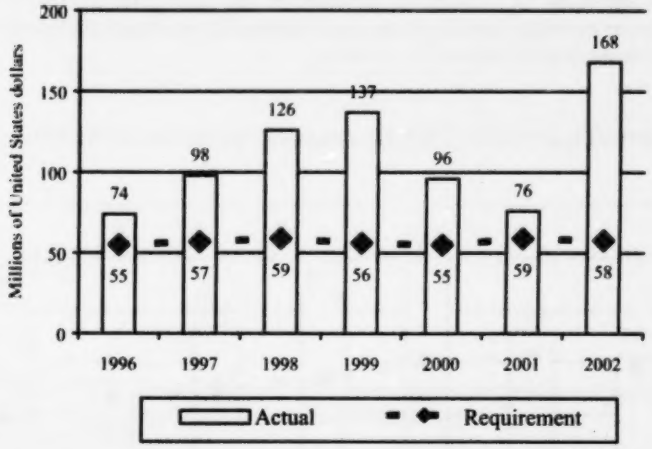
4. The Advisory Committee did not comment directly on the issue of the operational reserve in its report on the biennial support budget for 2002-2003 (E/ICEF/2001/AB/L.11). The Board of Auditors made no recommendation on the matter in its report on the UNICEF financial report and audited financial statements for the biennium ended 31 December 2001 (A/57/5/Add.2).

The question of establishing an operational reserve

5. Since its inception, UNICEF has not had a funded operational reserve, with the Executive Board opting instead to endorse a cash management approach to liquidity.

In 1987, the Board approved the existing policy which is outlined in paragraph 2 (b) above. The requirements of the policy have been met consistently since it was established. Table 1 below illustrates the experience for the period 1996 to 2002. Based upon the existing liquidity policy, UNICEF should have been holding at least $58 million in regular resources funds at the end of 2002; in fact, it was holding $168 million. The dramatic upturn in liquidity in 2002 resulted from foreign exchange gains associated with a weakened United States dollar and increased private sector income partly attributable to a one-time legacy contribution.

Table 1
Regular resources liquidity requirement, 1996-2003



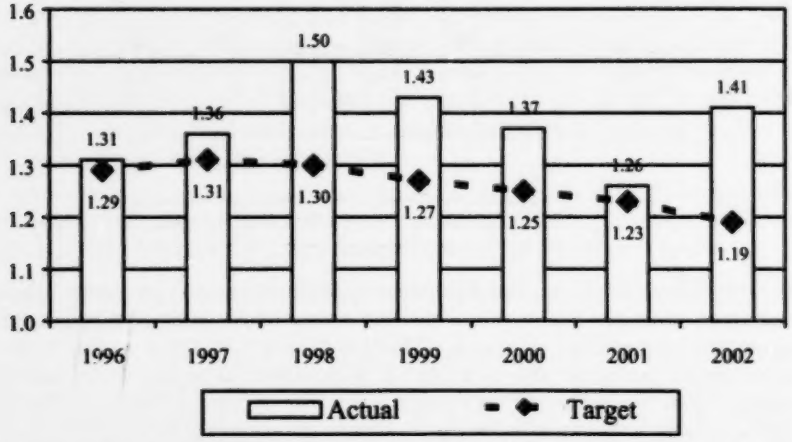
6. The annex to this document provides updated information on regular resources and other resources income since the last report to the Executive Board on the question of the operational reserve (E/ICEF/2001/AB/L.3). Other resources income continues to dominate and is expected to continue to represent an increasing proportion of income during the coming years. The increase in regular resources in 2002 was dramatically affected by a significant one-time legacy and from the foreign exchange impact of a weakening United States dollar. The composition of regular resources income is expected to revert in 2003 to the historical pattern with slowly increasing government contributions and an increasing trend in private sector income.

7. An additional measure of liquidity is reported in the financial statements. While not required by the Executive Board, this is an additional useful measure for judging the ability of UNICEF to meet its short-term cash requirements. This liquidity measure is based upon the ratio of short-term assets to short-term liabilities. Because other resources income is received in advance of expenditures, the liquidity ratio for other resources would be expected to be 1:1. For regular resources income, the liquidity ratio should be at least 1:1 but prudent financial management principles would dictate a ratio of 1.5:1. The ratio that is presented in the financial statements is a blend of the other resources and regular resources liquidity, which thus changes in relation to the relative weightings of regular and

other resources. For example, when other resources are equal to regular resources, this target weighted average ratio would be 1.25:1. As can be seen from table 2 below, there is some minor fluctuation in the target weighted average liquidity ratio but its variations are relatively smooth over a multi-year span.

8. Since the issue of an operational reserve was last discussed by the Executive Board in 2001, UNICEF has exceeded the 10-per-cent liquidity requirement established by the Board, as it has done since the measure was established. In addition, UNICEF has met the informal liquidity ratio reported in the financial statements. At the end of 2002, the weighted average liquidity ratio target, calculated on the basis of the regular resources/other resources split for the year, was 1.19 and the actual liquidity ratio was 1.41. The decline in the ratio from 1998 to 2001 was the result of a conscious decision by the secretariat to ensure, to the maximum extent possible, that resources are employed to meet the objectives of the organization through programmes for children.

Table 2
Liquidity ratio as reported in UNICEF financial statements, 1996-2002



9. UNICEF manages its liquidity on a daily basis in order to ensure the proper balance of its investment portfolio and the management of receipts and disbursements, to provide adequate funding for its offices around the world and to maximize the return on its investments. The Division of Financial and Administrative Management (DFAM) is responsible for the ongoing monitoring of the organization's banking and internal financial management systems.

10. An operational reserve would be one possible means of addressing sudden short-term events affecting programmes, but it would be merely a stop-gap measure that could be employed pending a longer-term correction of the organization's financial plan. A liquidity requirement, if properly managed on an ongoing basis, provides the same kind of short-term reaction mechanism.

11. The continuing commitment of donors to the UNICEF multi-year funding framework is improving this process as part of the organization's liquidity management. In addition, the National Committees for UNICEF have initiated more

regular transfers of funds, helping to smooth out cash flow and allowing for better financial planning and increased interest income via longer investment periods.

12. Of seven international organizations surveyed, only three had operational reserves (the International Labour Organization (ILO), the United Nations Development Programme (UNDP) and the World Food Programme (WFP)), only one of which, UNDP, included a provision for an other resources operational reserve. These three operational reserves for regular resources range from $21 million to $149 million and in all cases equalled roughly 5 per cent of total receipts for 2001. If UNICEF were to create an operational reserve based upon this principle, approximately $70 million would have to be set aside.

Table 3
Operational reserves of United Nations and other agencies

	Regular resources operational reserve	*Total receipts*
Agency	*(In millions of United States dollars)*	
UNDP	149	2 860
ILO	21	416
WFP	57	1 356
United Nations	-	7 000
FAO[a]	-	551
WHO[b]	-	1 179
OECD[c]	-	250

[a] Food and Agriculture Organization of the United Nations.
[b] World Health Organization.
[c] Organisation for Economic Cooperation and Development.

13. On the positive side, an operational reserve can provide a short-term response mechanism to address an unforeseen shortfall in receipts and income, and can also afford an opportunity to earn marginally increased interest income through longer-term investments.

14. On the other hand, an operational reserve creates a balance sheet asset at the expense of funding programmes, and may engender increased costs if it becomes necessary to break long-term investment commitments to utilize the funds.

15. On balance, the secretariat continues to believe that an operational reserve is not required, given the increased cooperation of its funding partners via the multi-year funding framework and the quarterly remittances from National Committees, and the organization's enhanced ability to manage and control cash management using its integrated computer information systems.

Recommendation

16. The Executive Director **recommends** that UNICEF continue to manage its liquidity in accordance with the liquidity requirement approved by the Executive Board and that it not establish a funded operational reserve.

Annex

Change in proportion of regular and other resources income, 1993-2002

(In millions of United States dollars)

Year	*Regular resources*	*Other resources*	*Total income*	*Percentage of other resources to total income*
1993	509	357	866	41
1994	535	471	1 006	47
1995	537	474	1 011	47
1996	551	393	944	42
1997	547	355	902	39
1998	571	395	966	41
1999	589	529	1 118	47
2000	563*	576	1 139	51
2001	551*	674	1 225	55
2002	709*	746	1 455	51

Regular resources income, 1993-2002

(In millions of United States dollars)

Year	*Government contributions*	*Private sector*	*Other income*	*Total regular resources income*	*Private sector share of regular resources income (%)*
1993	358	121	30	509	19
1994	361	129	45	535	21
1995	354	145	38	537	25
1996	364	151	36	551	27
1997	358	162	27	547	29
1998	344	182	45	571	32
1999	344	207	38	589	34
2000	343*	165	55	563	29
2001	351*	164	36	551	29
2002	368*	282	59	709	40

* Government contributions recorded at the gross level in order to be consistent with historical data.